STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	**02/21/08**	Bill No:	**AB 2461**
Tax:	**Property**	Author:	**Davis**
Related Bills:			

BILL SUMMARY

This bill would require the State Board of Equalization (Board) to conduct a study on the amount of revenue that would have been generated if nonresidential commercial property, as defined, had been reassessed at its fair market value in the prior fiscal year, and to report the results of the study, as specified, to the Department of Finance and the Legislature.

ANALYSIS

CURRENT LAW

Under existing property tax law, real property subject to taxation by the county assessor is reassessed to its current fair market value only when there is a “change in ownership.” (*California Constitution Article XIIIA, Sec. 2; Revenue and Taxation Code Sections 60 - 69.5)*

PROPOSED LAW

This bill would add Section 15606.7 to the Government Code to require the Board to conduct a study on the amount of revenue that would have been generated during the previous fiscal year if nonresidential commercial property had been reassessed at its fair market value that year.

For purposes of the study “nonresidential commercial property” means all property except the following:

- A constructed single-family or multifamily unit that is intended to be used primarily as a permanent residence, is used primarily as a permanent residence, or that is zoned as a residence, and the land on which that unit is constructed.
- Real property that is used and zoned for producing commercial agricultural commodities.

The results of the study are due to the Department of Finance and the Legislature on or before January 1, 2010.

IN GENERAL

Property Tax System. Proposition 13 approved by voters in 1978 substantially changed the property taxation system in California. In general, California's system of property taxation under Article XIIIA of the State Constitution (Proposition 13) values property at its 1975 fair market value, with annual increases limited to the inflation rate, as measured by the California Consumer Price Index, or 2%, whichever is less, until the property changes ownership. At the time of the ownership change, the value of the property for property tax purposes is redetermined based on current market value.

Change in Ownership. While Proposition 13 provided that a "change in ownership" would trigger reassessment, the phrase was not defined. The Assembly Revenue and Taxation Committee appointed a special Task Force - a broad based 35-member panel that included legislative and Board staff, county assessors, attorneys in the public and private sectors, and trade associations - to recommend the statutory implementation for Proposition 13 including its change in ownership provisions. The Task Force findings are published in California State Assembly Publication 723, **Report of the Task Force on Property Tax Administration,** January 22, 1979. A second report, **Implementation of Proposition 13, Volume 1, Property Tax Assessment,** prepared by the Assembly Revenue and Taxation Committee, California State Assembly Publication 748, October 29, 1979, provides additional information on how changes in ownership would be determined under Proposition 13.

Property Owned by Legal Entities. One issue the Task Force faced was how to apply the change in ownership provisions of Proposition 13 to property owned by a legal entity. For instance, would a transfer of ownership interests <u>in</u> a legal entity that owns real property be considered a transfer of the real property interests and, thus, a change in ownership? The Task Force considered two alternatives; the "separate entity theory" and the "ultimate control theory".

- **Separate Entity Theory.** The separate entity theory would respect the separate identity of the legal entity. Accordingly, for as long as the legal entity owned the property it would not be reassessed, even if all of the ownership interests in the legal entity had transferred.
- **Ultimate Control Theory.** The ultimate control theory would look through the legal entity to determine who held the ownership interests and, thus, who had "ultimate control" of the legal entity. Under this theory, real property owned by the legal entity would be reassessed only when a single holder of ownership interests gained control of the legal entity through the acquisition of a majority of those ownership interests.

The Task Force recommended that the separate entity theory be adopted for the following two reasons:

> "(a) The <u>administrative and enforcement</u> problems of the ultimate control approach are monumental. How is the assessor to learn when ultimate control of a corporation or partnership has changed? Moreover, when the rules are spelled out (and the Task Force actually drafted ultimate control statutes) it became apparent that, without trying to cheat, many taxpayers, as well as assessors, would simply not know that a change in ownership occurred. The separate entity approach is vastly simpler for taxpayers and assessors to understand, apply, and enforce. Transfers between individuals and entities, or among entities, will generally be recorded. Even if unrecorded the real property will have to be transferred (by

> unrecorded deed or contract of sale, for example). Taxpayers can justifiably be expected to understand that a <u>transfer of real property</u> is a change in ownership and must be reported to the assessor.
>
> (b) The ripple effects of ignoring the general separate entity laws of the state could not be predicted. The ultimate control theory threatened unknown disruptions of business organizations and practices. The separate entity approach avoids that pitfall by adopting the existing structure of corporate, partnership, etc. laws and building upon them."

The change in ownership definitions related to ownership interests in legal entities initially placed in statute in 1979 were based on the separate entity theory as recommended by the Task Force. However, thereafter, subdivision (c) of Section 64 was added which provided that a change in ownership occurred whenever there was a change in control by a transfer (or transfers) of more than 50% of the total ownership interests to a single person or entity.

According to **Implementation of Proposition 13**, Assembly Publication 748, subdivision (c) of Section 64, "the majority-takeover-of-corporate stock" provision, was added "out of a concern that, given the lower turnover rate of corporate property, mergers or other transfer of majority controlling ownership should result in a reappraisal of the corporation's property -- an effort to maintain some parity with the increasing relative tax burden of residential property statewide, due to more rapid turnover of homes. It was also a trade-off for exempting certain transfers among 100% wholly-owned corporations[1]."

Tax Burden. The Task Force was concerned that because commercial and industrial property changes ownership less frequently than residential property, a shift in tax burden to residential taxpayers could occur. The definitions originally proposed for legal entities (based on the separate entity theory) were chosen to mitigate administrative difficulties. Because of this concern, the Task Force proposed that the Legislature study the idea of a constitutional amendment to periodically appraise commercial and industrial property at current market value noting:

> "[s]uch a constitutional change would also result in far greater simplicity in the treatment of legal entities. If commercial and industrial properties were to be periodically reappraised for reasons <u>other than</u> change in ownership, the difficult and controversial policy issues in choosing between the 'ultimate control' approach or 'separate entity' approach, outlined previously, would largely be avoided. The Task Force commends the principle of such a change to the Legislature for additional study."

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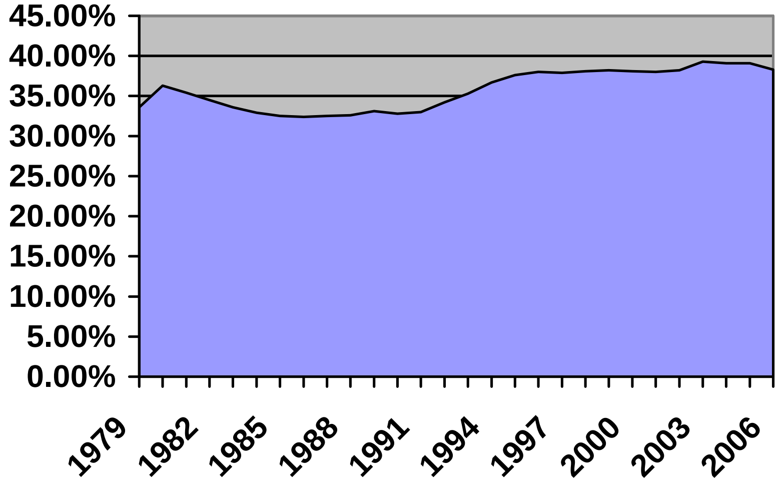
[1] Section 64(b) excludes transfers of ownership interests between affiliated corporations and Section 62(a)(2) excludes transfers which result in a change in the method of holding title to real property while the proportional ownership interests remain unchanged.

There is now 27 years of data to evaluate the Task Force concern that a shift in tax burden could occur. While the Board does not have statewide data on the percentage of *residential* property compared to all other property types, the following illustrates the **Percentage of Gross Assessed Value from Properties Receiving the Homeowners' Exemption** (i.e., owner occupied principal places of residence) **compared to total assessed value:**



1979-80	33.6%
1980-81	36.3%
1981-82	35.4%
1982-83	34.5%
1983-84	33.6%
1984-85	32.9%
1985-86	32.5%
1986-87	32.4%
1987-88	32.5%
1988-89	32.6%

1989-90	33.1%
1990-91	32.8%
1991-92	33.0%
1992-93	34.2%
1993-94	35.3%
1994-95	36.7%
1995-96	37.6%
1996-97	38.0%
1997-98	37.9%
1998-99	38.1%

1999-00	38.2%
2000-01	38.1%
2001-02	38.0%
2002-03	38.2%
2003-04	39.3%
2004-05	39.1%
2005-06	39.1%
2006-07	38.3%

The share of assessed value from owner occupied homes has increased from 33.6% in 1979 to 38.3% in 2006. The percentage change from year to year varies and in some years has declined.

BACKGROUND

Related Legislation. Legislation to (1) require annual reassessment of nonresidential property to its current market value via constitutional amendment and (2) redefine change in ownership as it applies to property owned by legal entities to current market value is summarized below.

Year	Bill	Summary
2005	SB 17(Escutia)	**Change in Ownership Definitions.** Provides that a change in ownership occurs when more than 50% of the ownership interests in a legal entity (excluding publicly traded companies) are transferred to one or more persons or entities during a calendar year.
2003	SB 17(Escutia)	**Change in Ownership Definitions.** Redefine change in ownership for nonresidential commercial and industrial property. (Legislative intent)
2003	ACA 16 (Hancock)	**Annual Reassessment.** Annual reassessment of nonresidential, nonagricultural property.
2003	SB 3X (Escutia)	**Change in Ownership Definitions.** Redefine change in ownership for nonresidential commercial and industrial property. (Legislative intent)
2002	SB 1662 (Peace)	**Change in Ownership Definitions.** Reassessment of nonresidential property when cumulatively more than 50% of the ownership has been transferred. Broaden the state and local sales and use tax base and reduce both the state and local sales and use tax rate. (Legislative intent)
2001	AB 1013 (Leonard)	**Change in Ownership Definitions.** Reassessment of property owned by a legal entity when more than 50% of the ownership shares transfer.
2000	AB 2288 (Dutra)	**Change in Ownership Definitions.** Reassessment of property owned by legal entity once every three years - Rebuttable presumption of change in ownership. Possible income tax credit to homeowners based on fair market value of homes from additional revenue. Reduce the sales and use tax rate by 0.25 percent.
1991	SB 82 (Kopp)	**Change in Ownership Definitions.** Reassessment of legal entities when cumulatively more than 50% of the ownership has been transferred.

Initiatives. Various initiatives to establish a split roll have been pursued.

Year	Result	Summary
2005	Dropped	**Annual Reassessment.** In part, requires annual reassessment of all nonresidential real property excluding property used for commercial agricultural production. (Submitted by Roberta B. Johansen and James C. Harrison)
2005	Dropped	**Split Tax Rate.** Increases the tax rate on commercial real property except commercial residential rental property by either .30% or .50%. (Submitted by Roberta B. Johansen and James C. Harrison)
2005	Dropped	**Split Tax Rate.** In part, increases the maximum tax rate from 1% to 3% on nonresidential property; counties set the actual rate at no less than 2%. Limits the 1% tax rate on residential property to the first $2 million. (Submitted by K. Heredia)
2005	Dropped	**Annual Reassessment.** Annual reassessment of all nonresidential real property excluding property used for commercial agricultural production and personal property exemption of first $500,000.(Submitted by Lenny Goldberg)
2005	Dropped	**Annual Reassessment.** Annual reassessment of all nonresidential real property excluding property used for commercial agricultural production and personal property exemption of first $500,000. (Submitted by Wayne Ordos)
2004	Signatures Collected& Initiative Dropped	**Split Tax Rate.** Increase tax rate to 1.5% nonresidential real property excluding property used for commercial agricultural production. Proponent: California Teachers Association & Rob Reiner
1992 Prop. 167	Failed 41.16% - 58.84%.	**Change in Ownership Definitions.** Addressed a number of tax related items, including a provision to modify the change in ownership definitions related to legal entities. Proponent: California Tax Reform Association

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author to obtain an estimate of the property tax revenue that would be generated if nonresidential commercial property was reassessed to current market value given the current budget crisis.
2. **This bill is just a study.** To reassess nonresidential commercial property to its current market value would ultimately require that voters first approve a constitutional amendment. Such a constitutional amendment might require annual, periodic, or a one-time reassessment to a base year more recent than 1975.
3. **What is a "split roll"?** When the phrase "split roll" is used, it generally means taxing certain types of real property according to a different standard of value or at a different tax rate. The split is typically between residential property (or the subset of owner occupied homes) and all other property types. For instance, rather than taxing all property at the same rate, nonresidential property would be taxed at a higher rate or at a higher percentage of market value. Within the framework of California's property tax system, the phrase is also used to describe any legislation attempting to redefine "change in ownership" as it applies to the purchase or transfer of ownership interests in legal entities (i.e., stock or ownership shares in a corporation or partnership) that own real property in a way that would trigger more frequent reassessments to current market value level.
4. **Recent split roll activity.** As noted in the Background section above, in recent years there have many efforts to require annual reassessments of nonresidential property, to increase the tax rate on nonresidential property, and to modify the change in ownership definitions for legal entities (which generally own nonresidential property). Proponents of these proposals state that over time the current system has become inequitable because property owned by a legal entity does not get reassessed as frequently as residential property owned by individuals. Opponents of these proposals state that the economic impact would be negative to the overall economy, businesses, employees, and consumers, and that California would become less competitive in national and global markets.
5. **State Assessed Property – Annual Reassessment**. California has a "split roll" with respect to locally and state assessed property. Property assessed by the Board is annually reassessed to its current market value. State assessed property includes property owned or used by telephone carriers, wireless carriers, radio-telephone carriers, gas, electric, and water companies, pipeline companies, railroad companies, railroad maintenance and private railroad cars. The Board's role is limited to determining the assessed value of these properties; the "Board roll" is then turned over to local counties for tax bill preparation and collection.

Valuation Method

State Assessment	Local Assessment
Current Fair Market Value	**Acquisition Value** Factored by no more than 2% per year or Current Fair Market Value, whichever is lower.

6. **Locally Assessed Business Personal Property – Annual Reassessment**. Businesses, unlike homeowners, also pay property taxes on their personal property holdings. Business personal property (such as machinery, equipment, computers, and furniture) is assessed every year to its current market value. Unlike real property, the value of this property generally decreases over time.

Valuation Method – Locally Assessed Property

Personal Property	Real Property
Current Fair Market Value	**Acquisition Value** Factored by no more than 2% per year or Current Fair Market Value, whichever is lower.

7. **The original 1978-79 Proposition 13 Task Force proposed that the Legislature study a constitutional change to periodically reappraise commercial and industrial property to its current market value in the future.** The Task Force considered and debated the issue of transfers of interests in legal entities. The Task Force recognized the effect of these definitions over the long term noting "(t)he Task Force admits that some of its own recommendations, such as those regarding legal entities, while the best of a seemingly 'no-win' choice of options and adopted to mitigate administrative difficulties, may, in the long run, further exacerbate this [tax burden] shift to residential property because it will result in fewer potential commercial and industrial property transfers being recognized for reappraisal purposes." Consequently, the Task Force proposed that the Legislature later study a constitutional change to periodically reappraise commercial and industrial property.

8. **Is the tax burden shifting to homeowners?** With respect to shifting tax burdens, the share of assessed value from owner occupied homes has increased from 33.6% in 1979 to 38.3% in 2006. The percentage change from year to year varies and in some years has declined.

9. **The Legislative Analyst's Office in 2001 addressed the disparity in the frequency of reassessment of property owned by individuals versus legal entities.** In a report issued to the Legislature by the Legislative Analyst's Office in 2001, "Reconsidering AB 8: Exploring Alternative Ways to Allocate Property Taxes," related to the frequency of reassessments for residential versus commercial and industrial property, they noted:

   ”For residential property, this acquisition value-based system has some policy merit. Specifically, it (1) encourages stable communities and (2) ensures no sharp increases in taxes from year to year (of particular concern for senior citizen homeowners on fixed incomes). At the same time, however, new homeowners – both first time homebuyers and those relocating - bear a disproportionate share of the residential property tax burden. It is only after a number of years of homeownership that the financial benefits of the acquisition assessment system accrue to homeowners.

   The same benefits of the acquisition value system exist in terms of commercial and industrial property; however, the disadvantages of this policy for businesses in a competitive economy are somewhat troubling. The system can present an economic barrier to entry for new businesses. If a competitor has been in the same location for a number of years, a new business faces higher operating costs. This can discourage the formation of new businesses and reduce competition."

10. **The Administrative Workload - Assessors.** Commercial and industrial properties are the most complex type of property to appraise. If California property tax laws are changed to require annual or periodic assessment of these property types, county assessors' offices would need to hire more real estate appraisers to handle the increase in annual real estate appraisal workload**.** Additional resources would be necessary to (1) identify nonresidential property affected, (2) appraise the properties annually, (3) defend or modify the appraisal pursuant to a formal or informal appeals, and (4) defend assessments in court actions.

11. **A specific reassessment date should be specified.** If enacted, this bill would be become operative on January 1, 2009 in the middle of the 2008-09 fiscal year. The "previous fiscal year" would be the 2007-08, and the lien date for that fiscal year would be January 1, 2007. For clarity a specific reassessment date for purposes of determining current market value should be specified. The following language is suggested:

    "…the amount of revenue that would have been generated during the ~~previous~~ 2007-08 fiscal year if nonresidential commercial property had been reassessed at its fair market value on January 1, 2007 ~~that year"~~

12. **The Board would need at least 18 months to complete the study and would need all counties to provide their local assessment rolls for the last two years.** Based on the workload, the due date should be extended to July 1, 2010 and the bill should be amended to require counties to provide the Board, at no charge, with an electronic copy of their assessment rolls for the 2007-08 and the 2008-09 fiscal years.

13. **Other Considerations:**

    Defining Nonresidential Properties. Types of properties where the residential vs. nonresidential classification may cause some difficulties, include:

    - Hotels (some hotels sell individual units as condominiums or time shares)
    - Motels (some motels are long term rentals)
    - Bed and Breakfast (owner-occupied)
    - Campgrounds – (permanent spots)
    - Timeshares
    - Assisted living facilities or convalescent homes

    Mixed Use Properties. There are parcels of land with residential and non-residential portions, either in separate or combined structures. In addition, there are properties that have a mixture of residential and non-residential within the same structure, such as live-work spaces and lofts.

    Commercial Agricultural Commodities." The phrase "used for commercial agricultural commodities" could be extended beyond the cultivation of land or the growing, raising, or gathering of commodities and the raising of livestock. For example, real property used in food processing, timber processing, and/or winemaking operations could be argued to be a commercial agricultural commodity.

COST ESTIMATE

The Board would need additional funding for limited term positions to perform this study. A detailed cost is pending.

REVENUE ESTIMATE

This bill has no revenue impact.

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This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.